



# Personal Insurance Federation of California

California's Personal Lines Trade Association

REPRESENTING THE LEADING AUTOMOBILE AND HOMEOWNERS INSURERS  
State Farm • Farmers • 21st Century Insurance Group • SAFECO • Progressive

## MEMORANDUM

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Date: March 18, 2005

To: The Honorable Juan Vargas, Chair  
Members, Assembly Insurance Committee

From: Dan C. Dunmoyer, President  
Michael A. Gunning, Senior Legislative Advocate  
Michael A. Paiva, Senior Legislative Advocate

RE: AB 527 (Levine): California Earthquake Authority  
Assembly Insurance Committee  
**PIFC Position: Oppose**

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The Personal Insurance Federation of California (PIFC), which represents insurers who sell approximately 49% of the business of the California Earthquake Authority (CEA) and nearly half of the residential earthquake risk in the state of California, **opposes AB 527**, authored by Assembly Member Levine.

Under existing law, the CEA Board consists of three voting members; the Governor, the Treasurer, and the Insurance Commissioner. Two additional, non-voting members are appointed by the Assembly Speaker and the Chair of the Senate Rules Committee. AB 527 would expand the number of voting members of the CEA Board from three to five and would give the Assembly Speaker and the Rules Chair the ability to appoint an individual to serve a four-year term.

PIFC opposes the expansion of the Board out of grave concern that such a change will jeopardize the tax-exempt status of the CEA. In addition, PIFC notes that the Board has not demonstrated a compelling need to make such a dramatic change to the Board, that such a change will impact the public's ability to scrutinize the operations of the CEA Board, and that by altering the CEA Board, the CEA may unwittingly damage their financial standing.

***Tax-exempt status threatened.*** The CEA enjoys tax-exempt status as a result of a November 8, 1996 Private Letter Ruling (PLR) from the Internal Revenue Service (IRS). In making this ruling, the IRS focused on two critical issues: (1) the degree of State Control over the enterprise (i.e. the composition of the Governing Board), and (2) whether the State had made a significant financial commitment to the enterprise.

In a memorandum commissioned by the Personal Insurance Federation of California, the legal accounting firm of Sutherland, Asbill & Brennan (Sutherland) notes that "any

departure” from the facts set forth in the CEA’s PLR of 1996 would make the PLR “inoperative.” (August 13, 2001 Sutherland letter) It is the reasoned opinion of Sutherland that if the CEA wants to make any changes to the Board, it must seek a new ruling from the IRS. In the words of Sutherland, “It is unthinkable that the CEA would not seek a new supplemental ruling before enactment of any further legislative changes.”

Sutherland notes that when the Legislature first introduced legislation to form the CEA, it sought a PLR from the IRS. This initial request was granted and a PLR was issued on February 28, 1996 granting tax-exempt status to the yet-to-be-formed CEA. According to Sutherland, when the IRS learned that the legislation had been amended, the IRS withdrew the PLR. As a result, the Legislature was forced to appeal for a new PLR which it did not receive until November of 1996. The Sutherland legal team uses this example to demonstrate its belief that the CEA must receive clearance from the IRS before initiating changes to the Governing Board.

PIFC notes that if the CEA lost its tax-exempt status today, it would owe a 35% federal tax on every dollar of taxable income. This means that there would be \$35 million less surplus for every \$100 million earned. That would result in less funding available to pay for earthquake losses and less investment income that could be earned on the saved taxes. Sutherland notes that this drain on CEA resources would “compound each year that the CEA is taxable.”

***If it isn’t broken, don’t fix it.*** At the February 24, 2005 CEA staff noted that the CEA has \$7.184 billion to pay claims, that the CEA could withstand a 1400 year event, and that CEA policies in force had grown to over 730,000. Given the fact that the CEA was formed amid considerable controversy and criticism just 9 short years ago, it is truly remarkable what this unique, public-private entity has accomplished. The success of the CEA begs the question, “why make changes to an entity that is performing well?”

***Preserve open meetings.*** The July 5, 2001 CEA Project Consulting Team Report noted that the Bagley-Keene Open Meeting Act “restricts the ability of Board members to communicate with each other and with staff.” The Bagley-Keene Act requires that CEA business be conducted in public whenever a quorum of the Board is established. Since the current Board is comprised of only three voting members, a quorum is established when two or more voting members are present.

PIFC notes that it does not know of any specific problems that the Bagley-Keene Act presents to the Board’s mission. However, to the extent that the Board desires to authorize individual Board members to meet outside of the public view, PIFC would be supportive of a limited exception to the Bagley-Keene Act for those occasions that the Board determines that private meetings are warranted. PIFC would view this limited exception as a far better solution than an expansion of the Board, particularly given the potentially dire consequences of such action. Furthermore, PIFC notes that in this era of “open government” the CEA would be best served by continuing to conduct business “in the open.”

***Protect the CEA’s favorable financial ratings.*** In December of 2002, the CEA received a financial strength rating of A- (Excellent) from A.M. Best Company, the world’s most authoritative insurance rating agency. This financial strength rating was reaffirmed in December 2004. CEA Chair Clark Kelso noted at the December 2004 Board meeting that he would be reluctant to pursue changes to the Board, in part because he did not want to jeopardize this extremely favorable rating. PIFC shares the concerns of the Chair and urges caution before making any changes to the over-all governance structure that might impact the CEA’s ability to secure the best rates on reinsurance.

In closing, PIFC would like to reference the cautionary message contained within the Sutherland memorandum. “In short, with the stakes so high, we think it would be irresponsible for the California Legislature to amend existing law without the CEA first obtaining a supplemental private letter ruling from the IRS regarding the tax consequences of any proposed changes. Inordinate complications could result from the adoption of any change that would subsequently have to be reversed in order to retain or restore the present tax-exempt status of the CEA.”

For the reasons stated above PIFC urges your opposition to this measure. If you have any questions, please contact Michael Paiva at (916) 442-6646.

cc: Assembly Member Levine  
Kevin Hanley, Assembly Republican Caucus  
Jim Anderson, Assembly Insurance Committee  
Cynthia Bryant, Office of the Governor  
Scott Reid, Office of the Insurance Advisor